DOW THEORY LETTERS INC.

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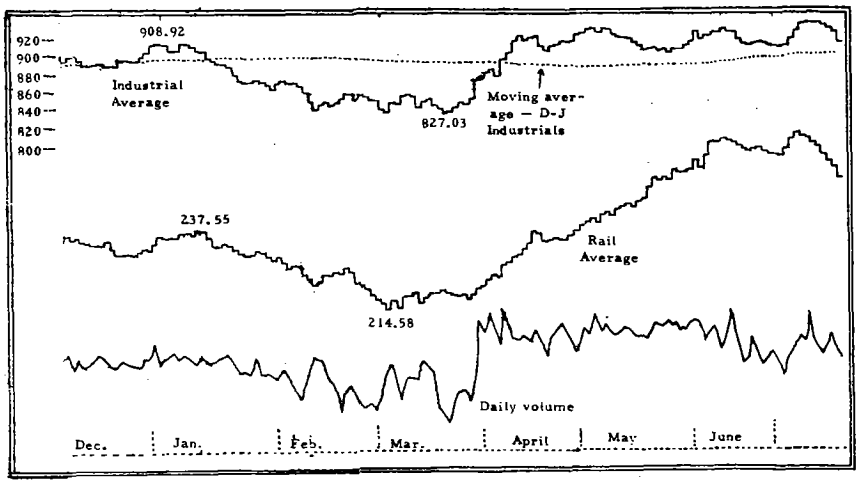
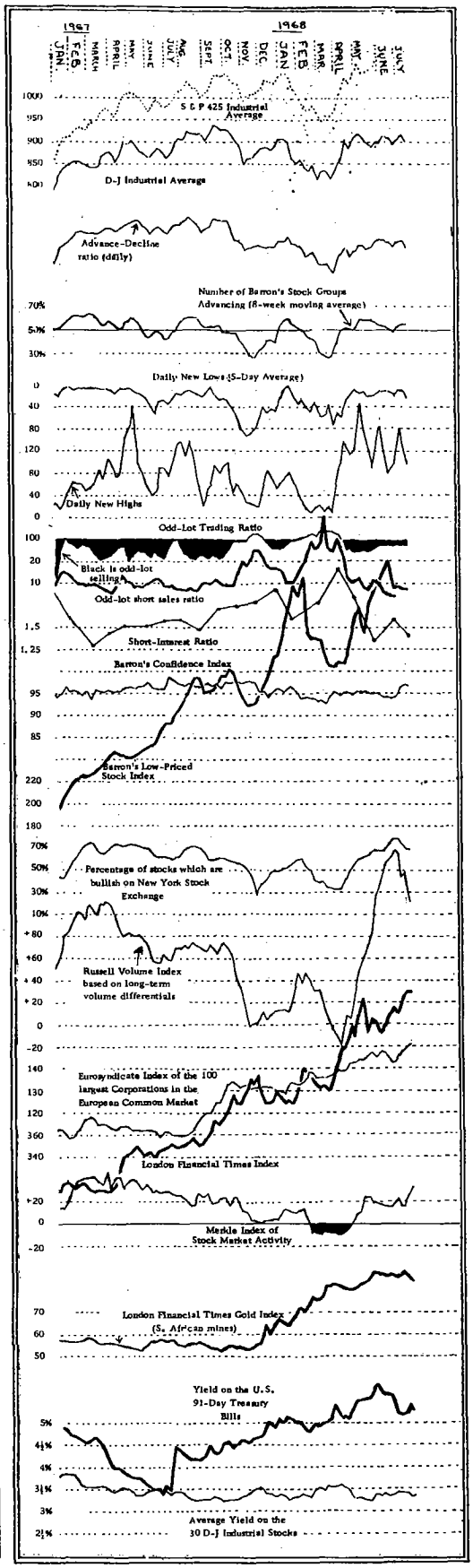
THE MARKET: The policy of investors throughout the world continues to be flight from paper currency. In the past 10 days the U.S., Dutch, Canadian, Japanese, and Swedish market averages rose to new 1968 highs. In England a lock of Admiral Nelson's hair sold for $466, while a few weeks ago a Gaughin painting brought a quarter of a million dollars. Everyone is searching desperately for some kind of article to swap for currencies, be they coins, rare stamps, paintings, stock certificates or what-have-you. Owners of vintage auto museums are "cleaning stock" at record prices, ancient airplanes are being sold to an eager public, antiques are going "out the window" at amazing prices, and the auction business is booming.

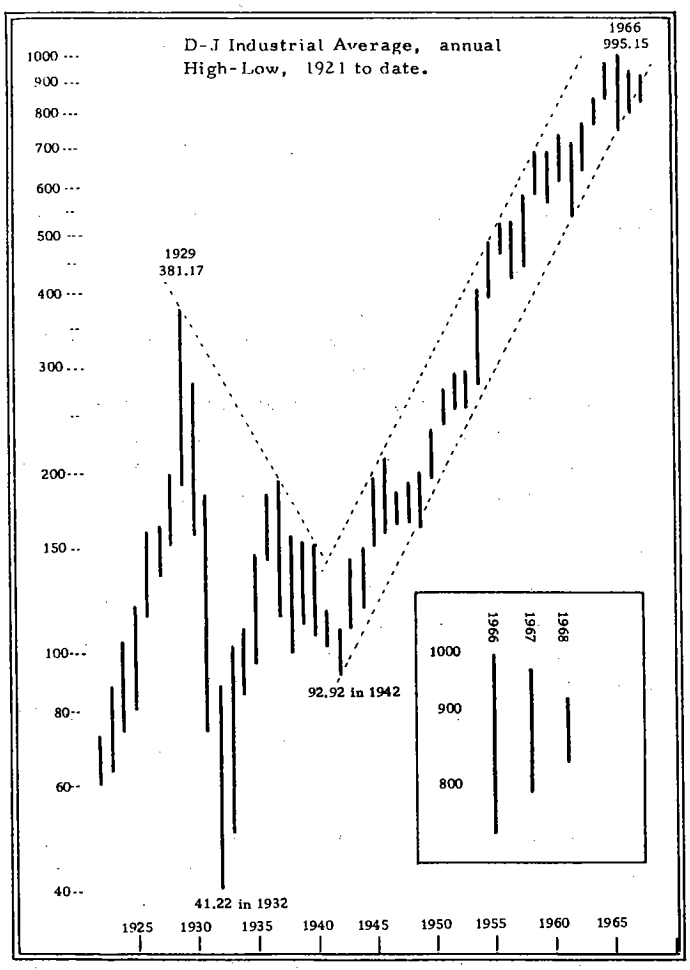
The fever for "things" is highly infectious, and out here in San Diego one can see it particularly in land prices and general speculation in buildings, franchises, new restaurants, and projects. Even our San Diego Sea World (which is a giant aquarium and fish circus) has issued stock to the public. Perhaps this would be a good time for our Government to get into the act. I would recommend that they auction off the U.S. Post Office in the form of franchises, then pocket the profits to pay off part of the national debt. The new franchises could not help but do a better job than the Government, as far as finances are concerned. Who knows, if they sold fried chicken and hamburgers in each local Post Office they might even offset the deficit in the mail delivery service and run the whole thing at a break-even level.

All but ignored today are the subtle forces of deflation, which are currently weak but undeniable showing themselves. There is the new 10% surtax (which is retroactive), and this will up the tax-take in individual and corporate taxes. There is the high cost of money, with interest rates still around the highest point of the century. People forget that interest rates constitute a fixed cost of doing business, and corporations and individuals (and governments) are now committing themselves to loans at rates which would not have been touched ten years ago. Finally, there is the climbing cost of labor and materials pitted against tough international price competition. Thus, many a corporation is going to see its profits squeezed in items which will not allow of a price increase. All these phenomena are deflationary in scope, and they will be coming into more prominence during the next few months and into 1969.




1967
1968
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline ratio (daily)
Number of Barron's Stock Groups Advancing (8-week moving average)
Daily New Lows (5-Day Average)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-lot short sales ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index based on long-term volume differentials
Euroyndicate Index of the 100 largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
London Financial Times Gold Index (S. African mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

Meanwhile, the N.Y.S.E. is at a particularly interesting juncture. The peak volume day of 21,350,000 shares occurred on June 13, 1968, with the peak of speculation occurring around April and May. Currently, the Exchange is simmering down slightly with the Dow Average around the early May level. Actually, remembering that the May 7 high was 919.90 on the Dow, we have made little progress in two months despite a flow of the greatest volume of transactions ever seen on the Exchange.



Back in Letter 397 I included the chart as shown again in this Letter. I want to draw the attention of subscribers to the small insert box showing the high-low range of the Dow during 1966, 1967 and 1968 so far. Note that each of the last two years have been "inside years" in that the Dow ranges have fit inside the range of the preceding year. We have never had three inside years, and this means that the odds for 1968 remaining an inside year are slim indeed. In other words, based on past history the odds heavily favor the Dow either rising above the 1967 closing peak of 943.08 or declining below the 1967 closing low of 786.41 before 1968 is out.

At present the great majority of investment opinion would obviously bet on a bettering of the 943.08 level. But whether this is what Wall Street has in store for us remains to be seen.

A few negative straws in the wind are worth noting. The advance-decline line has not confirmed the new 1968 peak in the Dow, and breadth has been sluggish over the past week. The Dow Rail Average has turned sloppy, and is now lagging the Industrial Average (the Rails can be likened to a speculative average). Paul Dysart's Negative Volume Index (the pleurality of advances over decline or decline over advances during declining volume days) has broken into new low ground. This indicator, historically, has had important lead characteristics. The Russell Volume Index (see page 1 composite chart) appears to have peaked out five weeks ago at a record figure of 158. The five-day differential of daily highs and lows seems to have topped out around June 15. The majority opinion is braced for "the traditional summer rally," but it occurs to me that there is a fair chance that the summer rally has passed.

I want to add a few paragraphs regarding the market's ability to discount. In my own experience, I have learned that I have to be exceedingly careful when handling material which I believe is "exclusive" or "unknown" to the market. Nine out of ten times, when someone provides me with inside information or a "secret" analysis, that so-called inside information is already known—and has been fully discounted by the market. A second consideration, as Robert Rhea was fond of pointing out, is that you may have advance knowledge of a coming event, but you can never be sure how the market will react to it—or when.

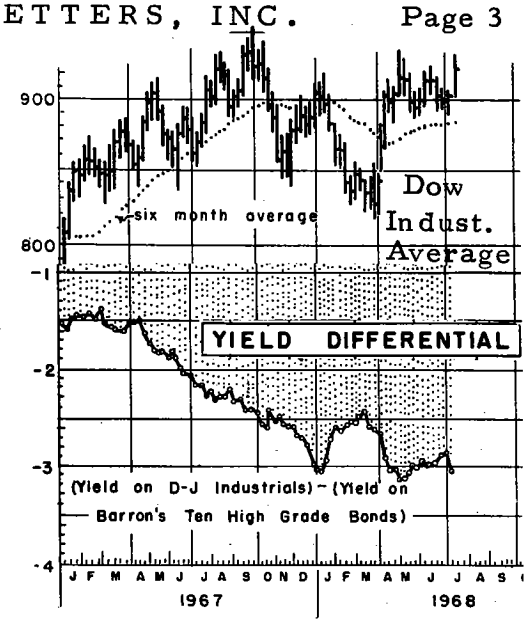
For instance, many informed men believe that Russia's price for a Vietnam peace will be a boost in the price of gold. It is a fact that the U.S. wants to end the Vietnam war. It is a real probability, then, that one of the conditions for an ultimate termination of the war in Vietnam will be a higher gold price. But how will this affect the market? When will it occur? Can we act on it?

A second instance, is that corporate profits are likely to be lower in the six months ahead. The surtax makes this a distinct possibility. But this is known, it is already built into the price of the Averages. It is almost hopeless to act on such known information.

At present, I feel (seat of my pants) that the market has been acting upon, and discounting, much or most of the good news which lies ahead. Here in the 900 area, the newspapers are full of rosy predictions, the price of gold has been battered down, the production indexes are way up, autos are selling like hot cakes, optimism is bubbling over. It is certain that when the market does turn down, it will turn down at or before the peak of good news.

When that happens everyone will say that the market is "crazy," that the news is too good to allow for a fall.

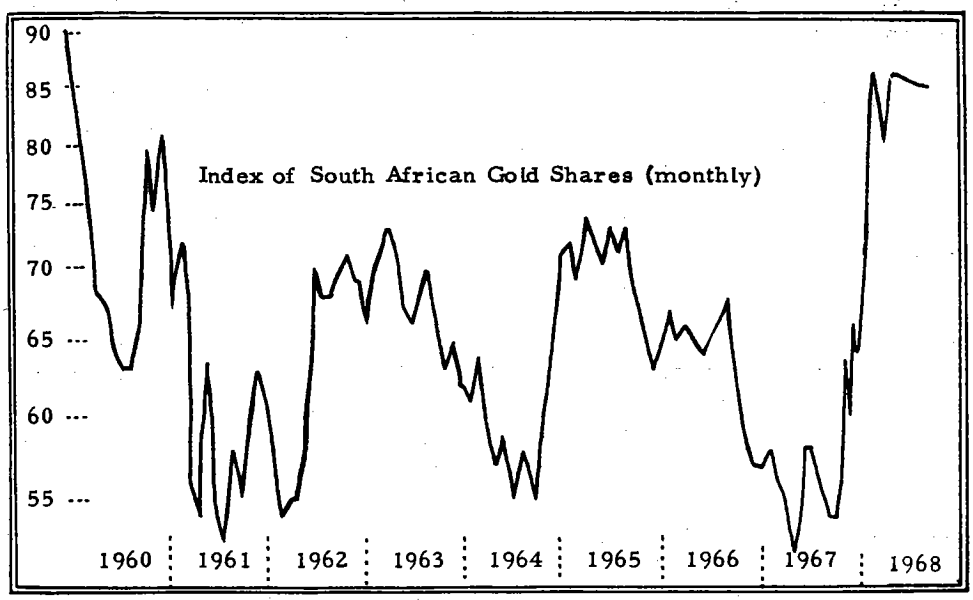
But such opinion fails to understand the meaning of the market. The market looks three months to a year ahead. When the best is foreseen, the market has done its "upside job," and it is ready to discount the coming trouble. When the worst is foreseen, the market is on the bottom and ready to turn up because things can only get better by definition.



NO CORRECTION: In the last Letter I presented a section on the weak bond rally. On the accompanying chart (courtesy of Merrill Analysis, Box 228, Chappaqua, N.Y.), we see the differential in yields between the D-J Industrials and Barron's 10 Highest-Grade Bonds. Note that as of the last reading, the yield differential was still in the low minus 3% area, near the lowest or most adverse yield differential on record.

This means that the yield differential now with the Dow at the 900 area is just as negative or bearish as it was in January, 1968 (Dow 908) just before the drop to the 1968 low of 825. This is true despite the recent bond rally, which has done little or nothing to correct the adverse spread on this chart.

Based on recent history (with high bond yields and low stock yields), the limit which the market will accept in the way of a negative stock-bond yield spread is slightly more than minus 3%. We are at that point again, now.



GOLD: From all accounts, the anti-gold forces are in the driver's seat. The passage of the U.S. surtax is considered a major victory for the dollar and therefore for $35 gold. The weakness of the franc has actually helped the dollar, in that it has weakened all currencies other than the dollar.

As a result, the money market has taken (limited) heart, and interest rates on the bellwether U.S. Treasury 91-day bills dropped two weeks ago to a low of 5.25%. But at the auction last week the bill yield jumped to 5.46%, highest yield since June 17. As mentioned last week, the Treasury bonds seemed to have run out of steam on their recent rally, and the whole bond rise from the lows continues to be unimpressive.

 Reacting to the chronic weakness in the pound, a group of 12 nations meeting at Basle have proposed a pool of $2 billion to support the pound. There is a widespread misconception that this is a loan, but it is not. It is a pool, and the money will be held outside Britain. This pool money will not help the fundamental British situation, it is simply another support operation. Furthermore, the fund will be up for voting at the I.M.F. meeting this September, if all 12 nations cast a positive vote.

As far as the U.S. position is concerned, it is best described by this paragraph from Reuter's financial editor, Sydney Gampell (from the July 8 Weekly Bond Buyer): "Since Washington's dollar saving package of Jan. 1, the U.S. trade balance has continued its collapse which started in October. In the three latest months, March-May, the commercial trade must have been in deficit at an annual rate of about $3 billion, partly freakish and fleeting but not all of it so easily explained away. Even including all the giveaway exports, two of those three months had deficits."

With it all, I have been particularly interested in the long-term chart of the South African gold shares. The gold index has backed off in a token way from the 88 high of a few months ago to last weeks figure of 85. Thus the index is still in the area of its nine-year peak and above all highs since 1960.

What I believe has been happening is that the world has begun to recognize (1) the real stability of the South African situation, and (2) the basic great value represented by many of the South African gold equities. I am convinced that there has been much switching out of the Canadian gold shares (which are relatively unimportant gold producers when compared to the leading S. African mines) and into the African equities. The low price/earnings multiples of the African mines is also an attraction to investors, particularly since the leading Canadian mines have been selling at such high multiples.

Thus, the current weakness in the Canadian shares (with Domes and Campbell Red Lake listed on the N.Y.S.E.) has given the public the impression that gold shares are showing outstanding weakness. But it should be remembered that South Africa produces 71% of the world's gold, and its gold index has held up remarkably well. Thus, the mass of leading gold mines (the S. Africans) have displayed marked resistance to the recent onslaught of adverse gold news and the recent weakness in the price of gold itself.

A summing-up comment was provided by the Christian Science Monitor on July 16: "Until the United States and Great Britain substantially improve their international payments, the international monetary system will totter on the brink of the unforeseeable, forced change. Confidence is a fragile element not easily restored."

MONEY TALKS: It may come as a shock to most people when they realize the role which money assumes in buying anything from a peace treaty to a boatload of people. For instance, the story goes that for a loan of $100 million to North Korea, the 84 crewmen of the ill-fated ship Pueblo would be returned to the U.S.

Next we hear that if Hanoi would only stop sparring around and really talk peace, they could get in on a giant U.S. loan to both Vietnams running into the billions of dollars. Thus the U.S. is seeking to buy peace in Vietnam via a huge "reconstruction" loan. But Hanoi turned the loan offer down.

Economist Elliot Janeway notes that Russia now owns probably $5 to $7 billion in gold rather than the $2 billion usually referred to. Therefore, Russia has a big stake in a gold price hike— preferably to around $75. The Russians would give the U.S. the right to invest in Russia if the U.S. would come through with $75 gold— but the U.S. is not interested. The U.S. might go $75 on gold if the Russians would supply a Vietnam peace, but the problem here is— could Russia really produce a peace (after all, China has a bit to say about peace in Vietnam too).

Best bet is that gold and U.S. dollars will figure prominently in any ultimate Vietnam settlement. In the meantime, the word is that nothing of note is going on at the Paris peace talks, which have now been reduced to a non-productive one-day a week meeting. Perhaps a tell-tale sign of the long talk marathon to come is the fact that Harriman and other leading U.S. talkers are now taking apartments in Paris as well as entering their children in fancy Parisian schools for the winter sessions.

SAN DIEGO: Many of my readers have again asked me to write something about San Diego. Perhaps ten subscribers have already moved to San Diego to work or retire, and since my arrival here in 1960 (from New York City) I have been a San Diego booster. The population (now 600,000) has been growing so fast that I don't feel impelled to talk up the city anymore, but I still love this area.

San Diego has what I believe is the best climate in the U.S.— probably the world. The mean temperature runs around 50 to 70 degrees all year around, somewhat on the cooler side in winter from late-October to April. We seldom have a

real heat spell, although once every two or three years (for a few weeks) the thermometer climbs to a dry 85 or 90. Rain is minimal, perhaps 10 days per year.

The city is given to outdoor living. It is plastered with golf courses, waterways, gardens, shoreline, surfing, beach areas, picnic areas, camping sites. It is located fifteen miles north of the Mexican border (the town of Tijuana), and this means that a foreign weekend (or afternoon) is always available. A few hours south of San Diego lies the great fishing town of Ensenada, Mexico, and south of Ensenada lies some of the wildest desert territory on the face of the earth.

Living is markedly cheaper in San Diego than most other places (particularly the East) in that clothing needs are minimal, the city is informal, dressing is extremely casual. Entertainment is cheap and in many cases free here. The entertainment has mostly to do with the outdoors, but there are many free concerts, civic-sponsored activities, and special events. The distances are great here, and you should drive a car if you want to enjoy what San Diego has to offer.

There are few gourmet restaurants in San Diego (or in the West in general), but good food is everywhere at quite reasonable prices. Restaurants here provide meals in the $2.50 to $3.75 range, while comparable food in New York City would cost double.

Perhaps most interesting to me is the sort of "classless" society which exists here. There is (unlike the East) very little of the feeling of "what did your father do?" or "How big is your income?" People seem to accept each other as people here, and perhaps that is a holdover from the old pioneering spirit (when people needed each other in order to survive). The social life here is very free, casual, and many might even call it rootless.

But perhaps because of this San Diego has become a Mecca for people encountering people, group encounter psychiatry, community inter-racial encounters. Everything is so available here that I believe it makes people wonder "what comes next, what can I do with my life, where am I going?" For instance, this weekend Western Behavior Science Institute of San Diego is running an experimental 50 groups of 10 each, and these 500 (!) people will just talk and learn about themselves and others through a weekend (the whole project is free and open to the public). This is the sort of thing happening in the West and particularly in San Diego. I find it fascinating, and I have found it nowhere else.

I guess what I am saying is that you can discover what you want here, whether it's weather and hunting, or people and examining your soul. I love the place, and you couldn't get me back to the crochety East with a crowbar.

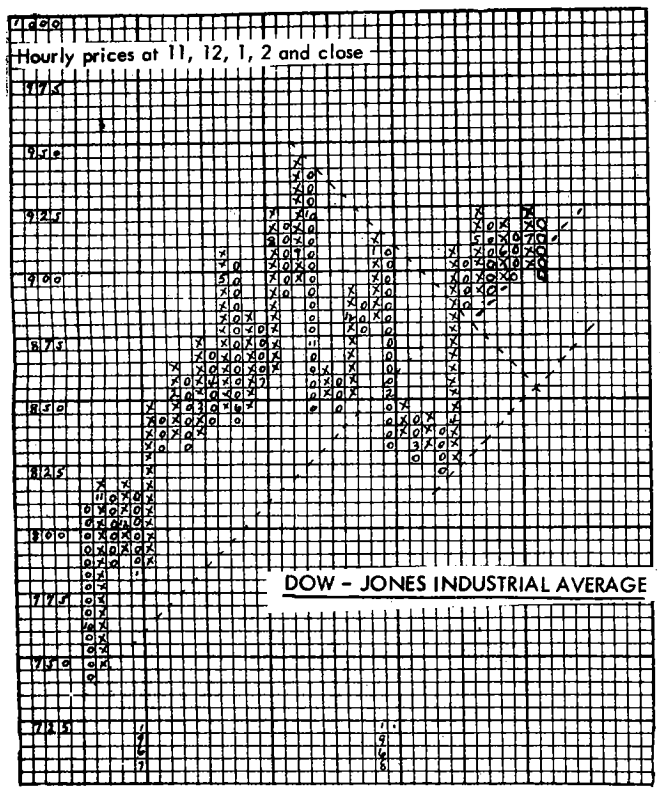
POINT & FIGURE: The point and figure analysis of the Dow at this point is particularly interesting. (For additional information on P & F, turn back to Letter 398). Here we see a P & F chart with each box representing 5 points. The vertical rows of X's signify advances in the Dow, O's represent declines.

Note that Monday's (July 22) decline took the Industrials down below the recently established rising trendline (dashed line on chart). This break below the trendline constitutes the first hint of trouble.

A second trouble signal would be a break to an hourly figure of 895 or below. Such a movement would mean that the Dow had broken below the last decline low.

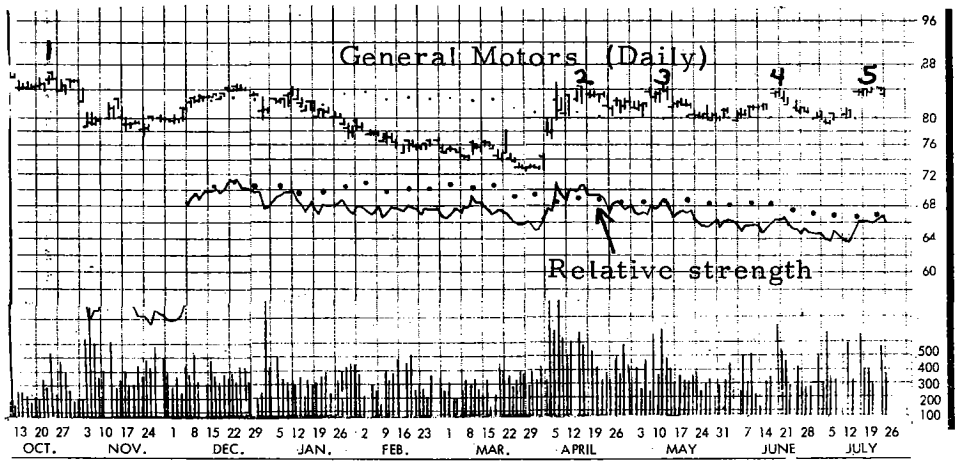
The whole "congestion area" since May is represented by the last six vertical rows of X's and O's. This area is bordered by two tops at 925 and a bottom at 895. An hourly Dow figure of 890 or less would violate the whole congestion area and would be a signal for lower prices ahead.

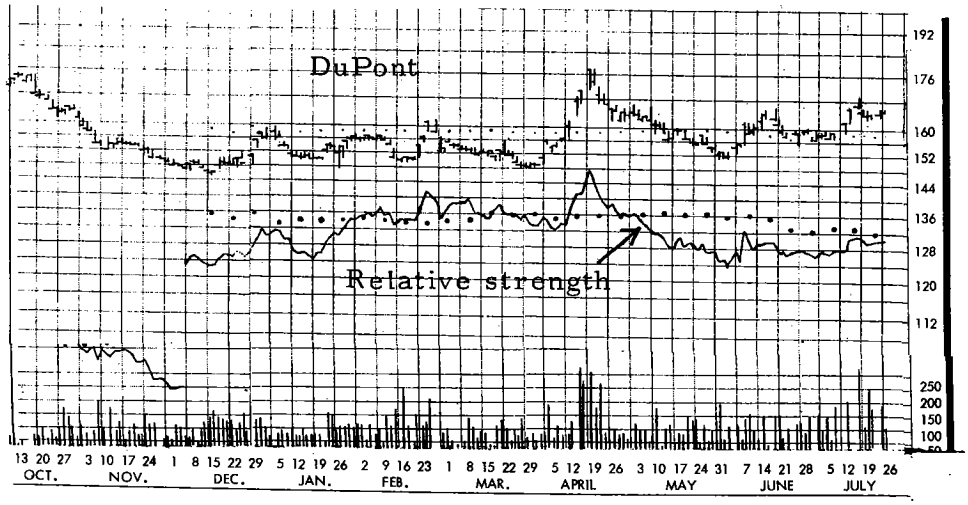
Finally, at 885 we have the 200-day moving average of the Dow (as seen on page 1). A plunge below this point would be my signal that the forces of the primary



43% - thirteen of the 30 DJI stocks are bullish.

bear market are again asserting themselves. I would consider a decisive drop below 885 as setting up the probability of a very bad autumn season for the market. In that case, I would not even be surprised to see the Dow plunge below the 744.32 low of 1966 as the primary bear forces envelope Wall Street in full—for the first time since 1966. (The P & F chart is courtesy of Chartcraft, Larchmont, N.Y.).





MARKET LAB: Accompanying are the daily charts of two of the bellwethers of the N.Y.S.E. (Charts courtesy of Traders Research, 101 Cherry St., Alton, Ill. 62002). As a rule, in all market history, the market will not go far without these two giant issues leading or at least following "in gear." Resistance by these two issues to general market rallies or declines means "watch out." The sheer number of workers employed by these two companies, their products, their sales, their purchases from suppliers, encompasses almost every segment of the American economy. The trend of their common shares is therefore vitally important.

Note that GM has pushed four times into the 84 area (marked 2, 3, 4 and 5) and this is the same area from which it turned down last October. Meanwhile, relative strength of GM (as compared with the S & P 500) is below the peak exhibited last December and April. GM has been running behind the market.

DuPont hit a high in the 176 area last April as volume flared. Since then it has declined to 152, then pushed up to the 170 area. Meanwhile, its relative strength line, after peaking in April, has turned flat during June and July. The entire movement in DD has taken place at or below last October's peak in the 176 area. Prognosis: DD has probably been under distribution in the 152-176 area.

LATE NOTES: On July 22 the Dow Industrials, following the persistent lead of the Rails, broke 13 points for their worst loss of the year. This took the Dow to the 900 area. One swallow does not make a Spring, and the first drop in the Dow does not prove a thing. Yet this does constitute the fourth failure by the Dow (in 1968) to penetrate the 920 area. Volume on the decline receded, but I warn readers to draw no comfort in this. In the history of the Averages, I know very few major declines which started on anything but contracting volume. Volume traditionally expands during the last third of a decline, with the heaviest volume appearing as the public finally senses disaster and throws in its shares.

The big picture is this—the top of the bull market occurred in February, 1966. Two and one half years have now passed since the top, and the Dow is still 100 points under the old high. This is a drastic departure from all Dow action since 1949 when the bull market started. While the old bull market was on, following all reactions, the Dow pushed to new highs within a matter of 15 months or so. That pattern has changed. The reason—the primary trend (despite the biggest upside fooler in bear market history) has changed.